INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute involved	2
Statement	3
Specification of errors to be urged	4
Reasons for granting the writs	11
Conclusion	18

CITATIONS

Cases:

Commissioner v. *Court Holding Co.*, 324 U. S. 331	12
Commissioner v. *Culbertson*, 337 U. S. 733	11, 12, 16, 17
Commissioner v. *Heininger*, 320 U. S. 467	18
Commissioner v. *Sunnen*, 333 U. S. 591	12
Commissioner v. *Tower*, 327 U. S. 280	11, 12, 17
Corliss v. *Bowers*, 281 U. S. 376	11
Deputy v. *du Pont*, 308 U. S. 488	15, 16
Dobson v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231	12
Gregory v. *Helvering*, 293 U. S. 465	12
Griffiths v. *Commissioner*, 308 U. S. 355	12
Gulf Oil Corp. v. *Lewellyn*, 248 U. S. 71	12
Harrison v. *Schaffner*, 312 U. S. 579	11
Helvering v. *Clifford*, 309 U. S. 331	11, 12, 17
Helvering v. *Lazarus & Co.*, 308 U. S. 252	14
Higgins v. *Smith*, 308 U. S. 473	12
Skemp v. *Commissioner*, 168 F. 2d 598	16, 17
Southern Pacific Co. v. *Lowe*, 247 U. S. 330	12
United States v. *Phellis*, 257 U. S. 156	12
Weiss v. *Stearn*, 265 U. S. 242	12

Statute:

Internal Revenue Code, Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	3, 11, 15, 117

Miscellaneous:

1950 P-H Tax Serv. ¶ 70, 293	17

In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 843

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HELEN C. BROWN AND EARL M. BROWN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Third Circuit entered in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 29-38), together with the dissenting opinion (R. 39-40), are reported at 12 T. C. 1095. The opinion of the Court of Appeals (R. 48-54) is not as yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on February 28, 1950. (R. 54-55.) The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

QUESTIONS PRESENTED

The taxpayers, husband and wife in partnership, transferred properties needed in their coal-mining business, which had cost $7,500, to their infant sons, in trust. Pursuant to a prearranged plan, the properties were then leased back to the taxpayers in consideration of "royalties", and "rentals" computed on the basis of tonnage loaded. During the tax year in question, these "rentals" and "royalties" amounted to more than $20,000. The Tax Court found that the "gift" and "lease" were a single transaction, that taxpayers never intended to part with their right to mine the coal and load and ship it from the properties which they had transferred, and that they "merely intended and made a gift of their partnership income in the amounts of the * * * 'rents' and 'royalties' to the trusts for their children" (R. 38). The questions presented are:

1. Whether the court below erred in reversing the Tax Court's factual conclusion that the "rents" and "royalties" paid by taxpayers were in reality gifts and therefore not deductible as business ex-

penses under Section 23 (a) (1) (A) of the Internal Revenue Code.

2. Whether the court below erred in reversing the Tax Court's factual conclusion that the "rents" and "royalties" were not "ordinary and necessary" business expenses within the meaning of, and so deductible under, Section 23 (a) (1) (A).

STATUTE INVOLVED

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

STATEMENT

The facts as found by the Tax Court (R. 31-35) are as follows:

Taxpayers are husband and wife, residing in Clearfield, Pennsylvania. Their individual tax returns for the calendar year 1944 were filed on the cash receipts and disbursements basis. (R. 31.)

Taxpayers were engaged as partners in the general contracting and coal-mining business. (R. 29, 37.) [1] In 1943 the business was growing. They owned a large equity in equipment worth about $150,000 and owned several coal properties which were then being operated. In their mining operations they made use of a railroad siding for loading coal, then owned by H. F. Bigler, Jr. The railroad siding consisted of a single track with a ramp or tipple from which coal could be loaded from trucks into railroad cars. The siding connected with the Baltimore & Ohio Railroad and was capable of holding approximately 30 coal cars. Taxpayers paid a wheelage charge of $2.50 a car, regardless of the amount of coal loaded.

[1] The Tax Court's formal findings of fact do not state the nature of taxpayers' business, but the opinion states that taxpayers, "as partners, were engaged in mining coal from several properties" (R. 37) and the syllabus to the opinion states that taxpayers "are engaged as partners in the general contracting and coal-mining business" (R. 29). Taxpayer Earl M. Brown testified (Tr. 28) that they were in the "Coal mining, general contracting and equipment rental business, and various other small matters" and that by "general contracting" he meant "Road building, roads and streets, bridges, coal stripping, removing overburden".

The amount of coal held by one coal car ranges from 50 to 70 tons. (R. 31.)

By deed dated June 7, 1943, taxpayers, as husband and wife, acquired from H. F. Bigler, Jr., and wife, for a consideration of $4,500, title to 8.9 acres of land located just outside the borough limits of Clearfield, Pennsylvania. The railroad siding was one of the improvements on this land. (R. 31.)

By deed dated September 29, 1943, taxpayers acquired for $3,000 a 35-acre tract of coal land located about three miles north of Clearfield and known as the Kephart tract. Testings had been made on this tract and evidences of coal discovered. Prior to January 3, 1944, taxpayers had commenced or were about to commence mining operations on this tract. (R. 31.)

Sometime prior to January 3, 1944, taxpayers discussed with their attorneys, Harry Boulton and his son, Harold J. Boulton, the matter of the future financial security of their two sons, Robert Earl Brown, born August 10, 1941, and Allan Murray Brown, born July 2, 1943. Harry Boulton suggested the creation of a trust. A plan was agreed upon whereby the title to the 8.9 acre tract upon which the railroad siding was located and to the 35-acre coal land was to be transferred to a trustee, with the understanding that the properties were to be leased to taxpayers, who were, as was always

intended, to continue to operate them under their partnership agreement. (R. 31-32.)

On January 3, 1944, taxpayers formally executed two irrevocable trust agreements, under each of which they conveyed to Harold J. Boulton, as trustee, an undivided one-half interest in the tracts for the benefit of taxpayers' two sons. The trust agreements are identical except as to the names of the beneficiaries. (R. 32.) Each trust contained, *inter alia,* the following provisions (R. 32-33):

> 1. During the continuance of the Trust, the Trustee shall have the absolute right, in his sole discretion, to operate, manage, sell, convey, transfer, lease, assign and convey any and all, or any part of the said Trust Estate, and to make, execute and deliver good and sufficient deeds, indentures or other written instruments to the purchaser or lessee at whatever price and upon whatever terms may to him seem wise; and the Trustee shall have the right to consent to assignments by lessees and to modify or cancel lease contracts for any part of the trust estate, if power and occasion should be reserved or arise under the terms of the lease agreement or agreements.
>
> * * * * *
>
> 3. The income from the Trust Estate shall be held and accumulated by the Trustee for the duration of the Trust but not exceeding twenty-one years after the death of the survivor of the grantors nor longer than the minority of the

beneficiaries; and he shall have the right at all times to pay out of the income at his discretion such sums as he may deem necessary for the support, maintenance and education of any of the beneficiaries who at the time of such payment would be entitled to receive all or part of the Trust Estate as though it were then terminated, and it is specifically authorized that the Trustee may invest any part or all of the income, or of the principal if converted into cash, in additional real estate or in leases of additional real estate. The income, after the dates fixed for accumulation thereof shall be paid from time to time to those entitled as though the trust had at the date of such payments been terminated.

4. The first beneficiary of the Trust Estate hereby created is ALLAN MURRAY BROWN, a minor child of the Grantors herein, subject to the hereinafter stated terms and conditions of the Trust; but if the said ALLAN MURRAY BROWN should die before attaining the age of twenty-five years, his surviving children in the first place, or if the said ALLAN MURRAY BROWN shall not have children to survive him, then his surviving brothers and sisters in the second place, in the order named, are substituted as beneficiaries.

5. The Trust Estate shall terminate upon the first beneficiary arriving at the age of twenty-five years; if the first beneficiary shall die prior to the date fixed for the termination of the Trust, the duration of the Trust Estate shall, nevertheless, so far as concerns the prin-

cipal of the Trust Estate, continue until the youngest of the respective substituted beneficiaries shall arrive at the age of twenty-one years, and the Trust shall continue for such substituted term with the same powers as herein set forth. Upon the termination of the Trust Estate, the Trustee shall execute sufficient conveyances and assignments in fee simple as to real estate and absolutely as to personalty, to the beneficiary or beneficiaries of all the corpus of the Trust Estate, including income which may have accumulated.

On January 4, 1944, the day after the trust agreement was executed, taxpayers entered into a written agreement with Harold J. Boulton, as trustee, whereby taxpayers were granted the exclusive right and privilege to occupy and use the railroad siding for a period of 10 years upon the payment of a rental of 7¢ per ton for each and every ton of coal or clay loaded upon the premises in railroad cars and shipped over the siding. In addition, the lessees (taxpayers) were to keep the railroad siding and equipment in good repair and were to save harmless and indemnify the lessor and the railroad from any loss, damage or expense by reason of injury to persons or property arising from use or occupation of the described premises, including any appurtenant sidewalks or driveways. The lease also provided for the payment of a minimum rental of $25 a month, prohibited the assignment or subletting without the lessor's consent,

and gave the lessor certain redress in case of default. (R. 33-34.)

Under the same date of January 4, 1944, taxpayers entered into another written agreement with Harold J. Boulton, as trustee, whereby taxpayers were granted, for a period of five years, the right to mine and take for their own use and benefit all the coal and fire clay upon the 35-acre tract acquired by taxpayers on September 29, 1943, upon the payment of 25¢ a ton for coal mined and 10¢ a ton for clay produced from the premises. The agreement also provided for the payment of a minimum rental of $50 a month, for which credit was to be given upon the royalty paid; prohibited assignment or subletting without the lessor's consent; and gave the lessor certain redress in case of default. (R. 34.)

The 25¢ a ton paid by taxpayers to the trustee for coal mined on the 35-acre tract and the 7¢ paid by taxpayers to the trustee for each ton of coal loaded over the railroad siding constituted reasonable royalties and rentals for the use of the facilities leased. (R. 34.)

The transfers of the coal acreage and railroad siding by taxpayers to the trustee of the trusts for taxpayers' children were integrated steps in one transaction. (R. 34.)

In 1944 taxpayers paid to Harold J. Boulton, as trustee of the two trusts, the sum of $10,278.90, representing royalties on coal mined on the 35-acre

tract, and the sum of $10,203.38, representing rentals for the use of the railroad siding. Taxpayers claimed these amounts as deductions on their partnership return for 1944. The Commissioner disallowed the deductions. (R. 34.)

The only person other than taxpayers who made use of the railroad siding during 1944 was H. F. Bigler, Jr. For such use he paid taxpayers $26. This amount was paid over by taxpayers to the trustee. Taxpayers did not report it in their partnership return of income for 1944. The Commissioner has included this amount as income in computing the income from business taxable to taxpayers. (R. 35.)

On the above facts, the Tax Court, with six judges dissenting, held that taxpayers merely intended and made a gift of their partnership income in the amount of the "rents" and "royalties" and that those amounts were not, and were not deductible as, "rents" or "royalties" or ordinary or necessary expenses of taxpayers' business within the provisions of Section 23 (a)(1)(A) of the Internal Revenue Code. (R. 35-40.)[2] The Court of Appeals for the Third Circuit reversed, with Judge Kalodner dissenting. (R. 48-54.)

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[2] The Tax Court also held that $26 paid to taxpayers by H. F. Bigler, Jr., for use of the railroad siding, and paid over by taxpayers to the trust, was income to taxpayers (R. 38). But that issue was not argued in or decided by the Court of Appeals.

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

1. In holding that the conclusion of the Tax Court that the "rents" and "royalties" paid by taxpayers were merely gifts was clearly wrong.

2. In holding that deduction of the "rents" and "royalties" is authorized by the language of Section 23 (a)(1)(A) of the Internal Revenue Code.

3. In failing to hold that the "rents" and "royalties" were not "ordinary and necessary" expenses of carrying on taxpayers' business.

4. In reversing the judgment of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. This Court's decisions dealing with the tax consequences of a reallocation of income within a family group establish two principles which control in such situations whatever the particular reallocation device chosen. Whether the reallocation is sought to be accomplished through the creation of a trust with retention of substantial ownership of the trust property by the grantor (*Helvering* v. *Clifford,* 309 U. S. 331) or through a so-called family partnership (*Commissioner* v. *Tower,* 327 U. S. 280; *Commissioner* v. *Culbertson,* 337 U. S. 733), the controlling considerations are the same: First, taxation is an intensely practical matter concerned with economic realities,[3] and tax

[3] *Helvering* v. *Clifford, supra; Harrison* v. *Schaffner,* 312 U. S. 579; *Corliss* v. *Bowers,* 281 U. S. 376.

consequences flow from the substance of a transaction rather than from its form.[4] Second, it is for the trial court, and particularly the Tax Court, to determine what is substance and what mere form,[5] and, in seeking to discover the economic realities, the trial court may properly view several steps in a transaction as being merely parts of a single integrated whole.[6]

The decision of the court below is in the face of both of these guides, authoritatively announced by this Court. Just as in the case of a *"Clifford* trust" or a "family partnership", what was here involved was a reallocation of income within a family, and the tax consequences must consequently be determined on the same principles. The taxpayers' avowed purposes in entering into the arrangement were, as the Tax Court stated, to provide financial security for their two minor children and, at the same time, leave their partnership business and business properties undisturbed in taxpayers' continued management and control. They effectuated these purposes by an arrange-

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[4] *Commissioner* v. *Tower, supra; Commissioner* v. *Culbertson, supra; Commissioner* v. *Sunnen,* 333 U. S. 591; *Commissioner* v. *Court Holding Co.,* 324 U. S. 331; *Higgins* v. *Smith,* 308 U. S. 473; *Griffiths* v. *Commissioner,* 308 U. S. 355; *Gregory* v. *Helvering,* 293 U. S. 465; *Weiss* v. *Stearn,* 265 U. S. 242; *United States* v. *Phellis,* 257 U. S. 156; *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330.

[5] *Commissioner* v. *Culbertson, supra; Commissioner* v. *Tower, supra; Helvering* v. *Clifford, supra; Commissioner* v. *Court Holding Co., supra.*

[6] *Commissioner* v. *Court Holding Co., supra;* cf. *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231.

ment whereby they formally paid "rents" and "royalties" for the use of two pieces of property which they had owned and intended to continue to use in their business. But the "rents" and "royalties" were not fixed amounts which might very well bear little relation to how the partnership enterprise would fare; both were measured by the business activity of the partnership—production and shipment (R. 34). Moreover, what the taxpayers gave to their children was income from the business, and not a remainder in the real property transferred. For the taxpayers expected to exhaust the 35-acre tract of coal land within the five-year period for which they leased it (R. 15), and the railroad siding apparently had little, if any, value except to the taxpayers (R. 35). Thus, the Tax Court was plainly justified in affirmatively answering the question presented for decision—"whether the transactions under consideration * * * were, in fact, an assignment or allocation by petitioners of their partnership income to the trusts for the children in the amount of the 'royalties' and 'rents' paid by petitioners." (R. 36.)

The reversal by the court below of the Tax Court's conclusion, that the payments made by taxpayers were not ordinary and necessary business expenses, must necessarily be interpreted either as an exaltation of form over substance or as a usurpation of the Tax Court's function of finding the substantive effect of a transaction, or both.

Either way or both ways, the decision of the court below marks a serious departure from the governing rules announced by this Court in the decisions already mentioned.

2. The decision of the court below conflicts in principle with the decision of this Court in *Helvering* v. *Lazarus & Co.*, 308 U. S. 252. There the Board of Tax Appeals found in substantial effect that the instrument under which the taxpayer purported to convey legal ownership to the trustee bank was in reality given and accepted as no more than security for a loan on the property; that the "rent" stipulated in the concurrently executed 99-year "lease" back was intended as a promise to pay an agreed 5 percent interest on the loan; and that the "depreciation fund" required by the "lease" was intended as an amortization fund, designed to pay off the loan in a specified number of years. Those findings, this Court stated, were supported by evidence which permitted at most conflicting inferences and were, therefore, conclusive on appeal. 308 U. S. at 254-255. The Court held that the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved. In the present cases, the findings of the Tax Court that the "gift" and "lease" back were a single transaction and that taxpayers never intended to part with their

right to mine the coal and load and ship it from the railroad siding which they had in form transferred, are more than amply supported by the evidence and should have been regarded as conclusive by the court below. From those findings and other findings made by it, the Tax Court justifiably reached the factual conclusion that the "rents" and "royalties" paid by taxpayers were in reality gifts, and were not ordinary and necessary business expenses within the meaning of Section 23(a)(1)(A). Under the decision of this Court in the *Lazarus* case, the court below was not warranted in reversing that conclusion.

3. The decision of the court below likewise conflicts in principle with that of this Court in *Deputy* v. *du Pont,* 308 U. S. 488. In that case, the taxpayer, among other things, sought a deduction under Section 23 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, which contained language identical to the present Section 23 (a)(1)(A) of the Code under which taxpayers are claiming a deduction for their payments of "rents" and "royalties". The deduction authorized then and now is for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business", including rentals, etc. This Court held in *Deputy* v. *du Pont, supra,* that, in determining what constitutes an "ordinary" business expense, "The fact that an obligation to pay has arisen is not sufficient"—that "It is the kind

of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling". (P. 496.) In the present case, taxpayers' obligation to pay "rents" and "royalties" arose from a transaction under which they gratuitously obligated themselves to pay the "rents" and "royalties" for the purpose of providing for the future financial security of their children, and not for any "benefit, advantage, or consideration" to the partnership in its business (R. 37). Nevertheless, the court below, instead of looking to the nature of the transaction pursuant to which the obligation to pay the "rents" and "royalties" was assumed by the taxpayers, ignored the Government's argument in that connection and held, by quoting from *Skemp* v. *Commissioner,* 168 F. 2d 598 (C.A. 7th), that the controlling fact was that taxpayers had incurred the obligation. This holding is directly contrary to the applicable law as enunciated in *Deputy* v. *du Pont,* 308 U. S. 488.

4. By according tax recognition to the formalities by means of which an allocation of income within the family group by a "gift and lease-back" arrangement is accomplished, the decision of the court below tenders a tax-avoidance device to those who might be otherwise unable, by reason of the immaturity of their children, for example, to accomplish that end through a family partnership. Cf. *Commissioner* v. *Culbertson,* 337 U. S. 733.

Under the decision below, the trusts, rather than the taxpayers, pay income tax on that part of the taxpayers' partnership income which is channeled to the trusts in the form of "rents" and "royalties", taxpayers being released from payment of the tax on that income by the holding of the court below that they are entitled to a deduction for the payments under Section 23 (a) (1) (A) of the Code. If the decision below stands, it is to be anticipated that this type of arrangement will be widely adopted in the future as a means of income splitting and tax avoidance,[7] especially now, when decisions of this Court have foreclosed use of the simple trust and family partnership devices.[8]

Whether taxpayers may successfully follow the pattern suggested by the decision below is a question of importance to them and to the Government. It is particularly important that a ruling be obtained from this Court at this time. As already indicated, this is not the first case of its kind to reach an appellate court; in *Skemp* v. *Commissioner,* 168 F. 2d 598, the Court of Appeals for the Seventh Circuit reversed a decision of the full Tax Court, similar to that here involved. In that case, there were but two dissents in the Tax Court;

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[7] In commenting on this case, the editors of a major tax service state (1950 P-H Tax Serv. ¶ 70, 293): "Each victory for a taxpayer points the way to a tax saving arrangement. Watch the progress of this line of cases carefully. Your Report Bulletin will keep you posted on new developments."

[8] *Helvering* v. *Clifford,* 309 U. S. 331; *Commissioner* v. *Tower,* 327 U. S. 280; *Commissioner* v. *Culbertson,* 337 U. S. 733.

in this, again before the full Tax Court, there were six, the dissenters relying heavily on the *Skemp* decision. There is a serious risk that if this case and *Skemp* stand unquestioned, the Tax Court will feel constrained to withhold its "independent judgment" and rule in favor of taxpayers in what we believe will be a "mistaken conviction" that tax recognition of the device with which we are here concerned is "required as a matter of law." Cf. *Commissioner* v. *Heininger*, 320 U. S. 467, 470-471, 475. To assure the benefits of an "independent" Tax Court judgment, review of this case by this Court is indicated.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

MAY, 1950.

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COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

HELEN C. BROWN and EARL M. BROWN, *Respondents*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENTS IN OPPOSITION

GEO. E. H. GOODNER,
Washington 4, D. C.,
Attorney for Respondents.

SCOTT P. CRAMPTON,
Washington 4, D. C.,
Of Counsel.

July, 1950.

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INDEX.

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	2
Statement	3
Argument	3
Conclusion	8

CITATIONS.

CASES:

Commissioner v. *Culbertson*, 337 U. S. 733	6
Commissioner v. *Tower*, 327 U. S. 280	6
Deputy v. *duPont*, 308 U. S. 488	6
Helvering v. *Clifford*, 309 U. S. 331	5
Helvering v. *Lazarus & Co.*, 308 U. S. 252	6
Skemp v. *Commissioner*, 168 F. 2d 598	6

STATUTES:

Internal Revenue Code:	
Section 22(a)	6
Section 23(a)(1)(A)	2
Section 1141(2)	3

MISCELLANEOUS:

Federal Rules of Civil Procedure, Rule 52(a)	3